20 January 2012

Dear Messrs. Mahes and Pietersz,

NAVA response to the CBCS proposed life and general insurance valuation guidelines

Thank you for giving us the opportunity to comment\(^1\) on the life and general insurance annual statements and valuation guidelines (valuation guidelines) as proposed by the Centrale Bank van Curacao en Sint Maarten (“the Central Bank”) in November 2011.

All insurance companies doing business in or through Curacao and Sint Maarten are required to annually file ARAS Statements (‘the Statements’) with the Central Bank, statements which provide a clear picture of the insurance business conducted by the insurer and its overall financial position. Although regulation\(^2\) is in place regarding these statements, currently no regulation or guidance on the accounting treatment is in place. This lack of accounting regulation creates questions for insurance companies and auditors and results in a variety of accounting methodologies used. This variety does not provide the Central Bank with comparable information on the overall financial position of the insurance companies.

For this reason, NAVA is appreciative of the Central Bank’s valuable work in this area and its commitment to bring more uniformity and consistency to the information that should be reported by the insurance industry.

Although NAVA really appreciates the approach the Central Bank has chosen, NAVA also has certain areas of concern. The concerns relate mainly to some specific valuation aspects, the auditors’ report, and the proposed effective date of the new valuation guidelines. In this letter we will disclose our concerns in further detail.

Valuation

To a large extent the proposed valuation guidelines follow Generally Accepted Accounting Principles, in particular the International Financial Reporting Standards (IFRS). NAVA

\(^1\) NAVA has taken due care in requesting input and comments from all the major local audit firms, however some audit firms did not respond to this request. Individual firms might therefore express different views.

\(^2\) the Bank’s "ARAS Annual Statement Instructions and Valuation Guidelines", (the Bank's Reporting Guidelines)
appreciates this approach. We would like to point out however large changes are ahead in IFRS in the coming years. Amongst others IFRS 9 (“Financial Instruments”) on financial assets changes the accounting treatment for financials assets significantly. In addition, based on IFRS 4 (“Insurance Contracts”), the financial statements of insurance companies will change significantly, specifically considering the impact on insurance liabilities. From a regulatory perspective, developments related to the EU Solvency II might also lead to significant future changes, specifically related to internationally structured insurance companies.

To avoid significant additional work and efforts for the purpose of the statements for Central Banks filing purposes as well as the annual financial statements, such as reconciling statements etc., we would like to point out the importance to follow these international developments and where applicable reflect those developments in a timely manner in the Statements.

**Uniformity and consistency**

With respect to the valuation guidelines in general NAVA notes the following. One of the goals of the Central Bank in publishing the valuation guidelines is to bring uniformity and consistency to the information reported by the industry. NAVA notes that the Central Bank has chosen to give insurance companies choices with respect to most of the balance sheet items. Both on the asset side as well as the liability side, choices in the valuation technique can be made. NAVA questions whether by giving these choices the goal of uniformity and consistency will be reached.

Not only will the valuation of specific line items differ between insurance companies, it also creates a different equity basis for each individual insurance company. As equity is an important component of the solvency calculation, the given choices do not seem to contribute to the desired uniformity and consistency. In this respect NAVA points out that for this reason the European Commission chose for a uniform set of valuation methodologies (market value) for all insurance companies in its Solvency II project on supervision of insurance companies. In the below paragraphs NAVA discloses concerns related to individual line items.

**Consolidation**

The Central Bank does not permit line by line consolidation of fully or partly (majority interest) owned subsidiaries. If these subsidiaries are supervised financial institutions in Curaçao or Sint Maarten, they are required to submit separate statutory statements to the Central Bank. If the subsidiary is licensed in a foreign jurisdiction, the Central Bank has appropriate guidelines in place to verify if that subsidiary is compliant with the foreign jurisdiction laws and regulations.

Instead of line by line consolidation a separate line item on “investments in subsidiaries” should be included in the balance sheet. The proposed valuation methodology of the subsidiaries is equity method. The accounting policies applied by the affiliated companies should be the same as those applied by the Insurance company. This means that, for the Statements, the valuation
guidelines of the Central Bank should be applied to determine the net equity value that needs to be reported to the Central Bank.

NAVA notes that if for determining the (equity) value of the subsidiary only the Central Banks valuation guidelines can be used, this could create an additional administrative burden for subsidiaries outside of Curaçao or Sint Maarten (as they will not apply the Central Bank’s valuation guidelines for their own financial statements or statements to local supervisors). The question could be raised whether this administrative requirement adds to the transparency or reliability in relation to the related cost to comply with this requirement. Although theoretically appropriate, the use of similar accounting principles for its foreign subsidiaries, might lead to significant additional costs to the supervised entities. NAVA would like to suggest allowing full reporting based on IFRS and in addition require this additional regulatory information to be included in separate Files.

**Intangibles**

Intangibles are not allowed in the balance sheet of the Statements. For supervisory purposes it is not unusual to leave capital components that are not immediately and without restriction at the disposal of the insurance company (such as intangibles) out of the calculation of the solvency margin of insurance companies. However for transparency reasons it could be questioned whether intangibles should be left out of the balance sheet. Does this give a true and fair view of the financial position of the insurance company? Goodwill/other intangible asset might also result in deferred tax assets. As alternative intangibles and other components that are not immediately and without restriction at the disposal of the insurance company could be included in the balance sheet and be visibly distracted in the solvency calculation in the relevant ARAS File (File 207).

Therefore the NAVA suggests that those balance sheet items should be deducted from the available equity instead of eliminating them from the balance sheet.

**Financial assets, stocks and bonds**

The Central Bank only allows insurance companies to include those financial assets that have a BBB rating (S&P or Fitch) or Baa rating (Moody’s). Securities with a lower rating than the investment grade are not allowed on the balance sheet of the statements. This requirement clearly deviates from most GAAP’s used by insurance companies and is only intended for supervisory purposes. In line with our comment on intangible assets, NAVA proposes as an alternative to include all financial assets that the company holds on the face of the balance sheet and to eliminate any financial assets with a rating that does not meet the criteria in the applicable solvency calculation sheets (File 207).

Furthermore with respect to most financial assets, insurance companies can choose between the cost model and fair value. If the fair value model is used, changes in the fair value should be reported in the revaluation surplus or in profit & loss account. Although the option to recognize changes in fair value in the revaluation account is now widely used (available for sale category in IFRS), NAVA notes that this is no longer allowed under IFRS 9, applicable as from 2015,
and as such will impact the alignment between future annual financial reporting based on IFRS and the Statements.

As additional question the NAVA wants to bring forward:

- What to do with the result realized in the statement of income on those financial assets that do not qualify according to the CBCS guidelines?
- Do the insurance companies need to report a reconciliation between reported balance sheet and statement of income based on IFRS to the Statements?

**Technical provisions (life and accident & sickness)**

The proposed valuation technique for life insurance is “Nominal value”. The described calculation methods allow two approaches: the “actuarial approach” and the “non actuarial approach”. Under the actuarial approach a calculation is described that does not seem to reflect “nominal value”. However, the “use of probability weighted future cash flows”, “discounting of cash flows at market rates” and “use of objective data and realistic assumptions and morbidity tables” seem to aim at a fair value valuation methodology rather than nominal value. Could the Central Bank clarify this in the final valuation guidelines?

In case it is the intention of the Central Bank to require fair value as a methodology, NAVA suggests to give further guidance on the following matters to enhance transparency, comparability and auditability:

- What cash flows should and should not be taken into account in calculating the technical provisions for life insurance contracts? Which methods are allowed or which boundaries are in place to determine the market interest rate that should be used for discounting? Will discounting rate be the risk free rate? If so, how should the risk free rate be determined? Any method allowed? Will a liquidity premium be allowed or even be required? Can each company determine its own interest rate? Can or will the Central Bank reject any used interest rates?

- The technical provisions should be calculated based on a prudent basis. However, the cash flows that should be taken into account should be measured “probability weighted”. This presumes that no particular prudence is included in the cash flows. In the calculation description no specific “risk or prudency margin” is described. Can or should a separate risk margin be added to fulfill the prudency requirement?

- Liability Adequacy Test (LAT): although the calculation method described seems to point at fair value measurement of the insurance liabilities, the Central Bank still requires a LAT to be performed. Can the Central Bank clarify the added value of performing a LAT if insurance liabilities are accounted for based upon fair value?

As we understand, currently no insurance company in Curaçao or Sint Maarten calculates the technical provisions of its life insurance business based upon fair value. Calculating the
technical provisions based upon fair value is a step that follows international developments. However, it will be a challenge for insurance companies to be able to calculate the technical provisions based upon fair value as per year end 2011, given the complexity and short time frame to realize this.

As an alternative, NAVA recommends requiring insurance companies to calculate the technical provisions “at cost” (specifying requirements such as maximum or minimum interest rates and items to be included or excluded) and perform a LAT that reflects current market conditions such as market interest rates and market assumptions.

As the LAT is an important measure to determine whether an insurance company can meet its future liabilities based on the recognized technical provisions, calculation of the LAT involves in most circumstances an actuary. NAVA therefore would like to suggest the LAT to be certified by an external actuary. This could be done by creating a separate LAT File or to include LAT disclosures in other existing files that are certified by the actuary, applying LAT in agreement with IFRS 4.

Auditors’ report

The statement should be accompanied by an external auditors’ report. NAVA recommends the following changes with respect to the auditors’ report:

Text of the independent auditors’ report.

The Central Bank included a model of an unqualified auditor’s report in the valuation guidelines. With respect to this model we would like to add or change the following:

- For identification purposes NAVA suggest to include the unique security code into the (standard text of the) auditor’s opinion;
- In the scope paragraph, the model of the independent auditors’ report states that we conducted our audit in accordance with Dutch Law including the Dutch standards on auditing. NAVA suggest rephrasing this to the following “we conducted our audit in accordance with International Standards on Auditing (ISA)”. As Dutch Law is not applicable in Curacao and/or Sint Maarten, referring to Dutch law does not seem appropriate. In addition, most local audit firms currently apply ISA.
- According to Article 5 of the “Landsbesluit Financiele Staten Verzekeringenbedrijf”, File 128 is a public file; therefore the distribution restriction paragraph within the Auditors’ report should be deleted. NAVA suggest bringing the model of the unqualified auditors’ report in line with the latest version of the model as prescribed by the International Standards on Auditing holding a separate paragraph stating management’s responsibility and the responsibility of the auditor.

For your convenience we have attached a suggested model of an unqualified auditors’ report (on life insurance) as appendix A to this letter.
Including the auditors’ report in the Statements

One of the issues raised during the presentations of the Central Bank regarding the valuation guidelines was the following: the insurance company has to include the auditors’ report in File 128. However including the auditors’ report after the closing procedures would result in the change of the unique security code. This seems to create a circle. NAVA has the following suggestions for this issue:

- The auditors’ report will only be delivered in hard copy. The Central Bank excludes this auditors’ report File from the ARAS; or
- The Central Bank changes its set up of the unique security code, in such a way that adding an auditors’ opinion to the Statements does not change the unique security code (this option is currently used in the Wft staten required by De Nederlandsche Bank (DNB));

Closing procedures before submitting the Statements

Upon finalization of the Statements the insurance company is required to perform a close out procedure (pushing the red button). By performing this procedure a unique security code is created for identification purposes. In the current set-up any changes made in the ARAS files will, result into a change of this code. NAVA would like to verify the security aspects related to the integrity of this code in order to assure that this code cannot be corrupted or that the insurance company cannot make any unauthorized changes after submitting or audit of the figures. If such verification is not possible, NAVA suggests agreeing upon a specific protocol arranging the agreements between auditors and the Central Bank regarding the identification of the Statements. One of these agreements that the Central Bank could consider is to accept the full responsibility by the Central Bank for the integrity of the unique security code. It is NAVA’s suggestion to discuss integrity of the security code separately with the Central Bank to reach mutual agreement.

Timing

The Central Bank has indicated that it expects to publish final valuation guidelines in February 2012 with an effective date of 1-1-2011. The short transition date might give to operational or financial issues for some insurance companies as most companies have already closed the financial year and started drafting the Statements. We would like to ask the Central Bank’s views and guidance in relation to the solvency ratio’s published in the 2011 Statements: should those be based on the new or on the current guidelines? Considering these aspects related to transition, NAVA welcomes the recently published adjusted timing of the Central Banks implementation of these new guidelines, specifically as at present most insurance companies use valuation methodologies for the Statements comparable to the valuation methodologies the company uses for its annual financial statements based on IFRS. The proposed valuation guidelines deviate from Generally Accepted Accounting Principles (GAAP) at certain balance
sheet and profit & loss items. This means insurance companies will need time to make changes to their accounting policies and, in some cases, systems, to be able to provide the information according to the valuation guidelines of the Central Bank.

We thank the Central Bank for giving us the opportunity to comment on the published draft valuation guidelines. In case you wish to discuss any of the issues addressed in this letter please contact Mr. André Delger at delger.andre@kpmg.an or by phone at 5229888

Kind regards,

On behalf of NAVA

drs. André J. Delger RA       drs. Peter Bongers RA
Technical Committee of NAVA       Chairman of NAVA
Appendix A  Independent unqualified auditors’ report

Introduction

We have audited the Life Insurance Annual Statement and Separate Accounts Life Supplemental Annual Statement of [Name insurance company] as at December 31, 201X as presented in File 100 up to and including File 128 and file S00 up to and including File S20. The Statements have been submitted through the ARAS systems of the Centrale Bank van Curaçao en Sint Maarten. The unique security number of the submitted Statements is [insert number]. The statements have been drafted in accordance with the Life Insurance Annual Statement Composition and Valuation Guidelines (2011) of the Centrale Bank van Curaçao en Sint Maarten.

Management’s responsibility for the statements

Management is responsible for the preparation and fair presentation of these Statements in accordance with the Life Insurance Annual Statement Composition and Valuation Guidelines (2011) of the Centrale Bank van Curaçao en Sint Maarten, and for such internal control as management determines is necessary to enable the preparation of the Statements that are free from material misstatement, whether due to fraud or error.

Auditors’ responsibility

Our responsibility is to express an opinion on the Statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with relevant ethical requirements and plan and perform the audit to obtain reasonable assurance whether the Statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the Statements. The procedures selected depend on our judgment, including the assessment of the risks of material misstatement of the Statements, whether due to fraud or error. In making those risk assessments, we consider internal control relevant to the entity’s preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity’s internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

3 Please note that in case of audit findings, different auditor’s opinions with qualifications and/or a paragraph of matters affecting opinion, might be required in conformity with International Standards of Auditing.
Opinion

In our opinion, the Life Insurance Annual Statement and Separate Accounts Life Supplemental Annual Statement of [name insurance company] as of [month, day, year] has been prepared in all material aspects in accordance with accounting policies defined in the ‘Life Insurance Annual Statement Composition and Valuation Guidelines (2011).

Date,

[Signoff]